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SUBJECT: INDIA STIMULUS PACKAGE AND MORE MONETARY EASING: CONTINUING MODEST STEPS IN THE RIGHT DIRECTION

REFTEL NEW DELHI 2995

¶1. (SBU) Summary. The government on December 7 announced a fiscal stimulus package, in step with global calls for boosting consumer demand, while the central bank announced lower interest rates and other steps aimed at helping those sectors hardest hit by the financial crunch. The stimulus package had been anticipated but disappointed market observers because of its modest size (just "up to" $4 billion). However, many economists have noted that the government has little fiscal space for much additional spending, as the current budget is already expansionary and exceeds fiscal spending targets. Lower policy rates have prompted signs of banks reducing their lending rates, but this will take time to cycle through the economy. Many analysts still expect further monetary easing, which declining inflation will permit. New economic data suggests the economy continues to slow, but conflicting data prevents a clear picture of how much. End summary.

FISCAL STIMULUS PACKAGE

¶2. (SBU) In line with G-20 consensus after the November 15 Summit, India unveiled a stimulus package on December 7 aimed at boosting consumer demand and confidence. The key aspects of the package are a pledge to spend up to $4 billion more through the end of the current fiscal year on March 31, 2009; it lowered the "cenvat" tax - a tax on manufacturing - by 400 basis points and lowered petrol and diesel prices by roughly 10% and 5% respectively. The reduced cenvat will cost an estimated RS 87 billion ($1.8 billion) in foregone revenues.

¶3. (SBU) The response was mostly disappointment as the promised spending is very modest, with no specific spending plans, and some industry sectors had hoped for specialized help. But, as mentioned reftel, the government has not had much room to increase spending, as it has been running an expansionary, pre-election budget since April. Skyrocketing commodity costs earlier this year also propelled oil and fertilizer subsidies to unprecedented heights and pre-empted much of the government's potential spending power. Indeed, in the supplementary budget demand in November, the government asked for an addition Rs. 2.3 trillion ($40 billion) - ten times the current fiscal stimulus package. The grants were needed to pay for several programs that had not been funded in the budget, including the oil and fertilizer subsidies, the government wage increase, farmer debt waiver program, and the rural employment guarantee program.

RBI LOWERS INTEREST RATES

¶4. (U) The same weekend, on December 6, the central bank, the Reserve Bank of India (RBI), announced a long-anticipated reduction in its main policy rate, the repo rate, lowering it by 100 basis points from 7.5% to 6.5%. Responding to banks' recent preference for parking funds with the RBI under its reverse repo rate, rather than deploying the capital, the RBI also lowered that rate from 6% to 5% in order to discourage the holding of needed capital.

¶5. (U) The central bank announced additional measures targeted at the hardest hit sectors, particularly "the housing, export and small and medium industry sector." These include providing a refinance line of Rs. 70 billion ($1.4 billion) to the Small Industries Development Bank of India (SIDBI) to enhance credit to small and medium enterprises (SME). The RBI also lowered the ceiling on the finance rate for export credit as well as offering a 2% interest subsidy to exporters. Furthermore, the central bank also announced that it would give "priority lending" status to loans below Rs. 2 million ($40,000) granted by banks to Housing Finance Companies (HFCs) for lending to individuals for purchase/construction of residential units. On December 11, the RBI announced measures "to preserve financial stability and arrest the moderation in the growth momentum." The RBI extended additional support to the housing sector by providing a Rs. 40 billion ($800 million) refinancing to the National Housing Bank (NHB) against loans and advances to HFCs. To ease pressures on loan disbursements to Indian exporters and for honoring disbursements under export lines of credit, the RBI decided to provide a Rs. 50 billion ($1 billion) refinancing facility to the Export Import Bank of India.

¶6. (SBU) Mumbai-based economists and analysts agreed that these

steps were good, but still not enough to overcome the reluctance of Indian banks to lend. Dr. Rupa Nitsure, Chief Economist at the Bank of Baroda, stated that RBI's actions were meant to be counter-cyclical, but "would not lead to miracles." The RBI, by reducing interest rates, was now looking at reducing the cost of funds for banks so they, in turn, could provide access to capital at reasonable rates to cash-strapped companies. However, she pointed out that the State Bank of India (SBI), India's largest bank, was attracting large numbers of savers with a rate of return of 10.50 percent for some new deposits; due to this demand, other banks were forced to raise their deposit rates to compete for funds. As a result, banks were unable to bring down lending rates without compressing already thin margins, unless deposit rates also were lowered. She recommended that the RBI should ask banks to reduce lending rates for certain sectors instead of across the board.

¶7. (SBU) Dr. Siddharth Roy, Chief Economist of Tata and Sons, pointed out that while the RBI has reduced the Cash Reserve Ratio and repo rate in a series of moves, more reverse repo rate cuts are needed. Roy asked why in the current uncertain environment banks would lend to businesses if they can receive a fairly high five percent risk-free return from the RBI in the form of reverse repo by depositing their funds there. He applauded the recent reverse repo rate cut by one hundred basis points but said more needs to be done. Roy stated that bank deposit rates are still high, so lending rates have stayed at high levels.

IMPACT OF MEASURES

¶8. (SBU) There are initial signs that the monetary steps are working to lower the cost of capital in the system, with state-owned banks announcing a new housing package and two state-owned banks deciding to lower their deposit rates, which give them - and other banks - room to lower lending rates as well. Several market analysts expect both the repo and reverse repo rate to come down further, further enabling banks to lower interest rates from what is currently among the highest India has seen in nearly two decades. Lower rates will make financing affordable to more companies and consumers, which could prompt banks to revive lending, something they have been loathe to do, as seen by high deposits with the central bank. However, while lower interest rates are critical to easing growth conditions, most estimate that they have at least a 12-month lag.

¶9. It will be more difficult to measure the impact of the stimulus package on the spending side, although the cenvat reduction has already prompted some automakers, including market leaders Maruti Suzuki and Tata Motors, to announce they would pass on the tax cut to consumers. Commerce Minister Nath, former Finance Minister Chidambaram, and Planning Commission Deputy Chairman Montek Singh Ahluwalia have made statements in recent days supporting further fiscal measures as warranted.

OUTLOOK

¶10. (SBU) The RBI's October and November measures have succeeded in returning liquidity to India's financial system. Now the challenge is to get banks to feel comfortable lending again in a tougher economic climate that includes slower manufacturing activity, exports, and the possibility of substantial job cuts. Many think that the repo rate is still too high for many consumers and businesses and must come down to 5.0 or 5.5%, i.e., at least another 100 or 150 basis points.

¶11. (SBU) Recent macroeconomic data continues to add to pessimism. Early assessments of November exports suggest another month of contraction, while the index of industrial production (IIP) recorded the first contraction on the index's 15-year history in October. Excise and customs revenues were down and advance tax payments are expected to dip as well. However, the IIP has been experiencing several glitches in data collection and is contrasted by April-September sales revenues of listed companies, which continue to paint a robust consumption picture, with sales up 30% compared to the same period in 2007.

¶12. (SBU) At the same time, some of the indirect revenue losses are due to the government's tariff and tax reductions in the spring and

summer when it was combating rising inflation. And advance tax payments could be suffering from the reluctance of companies to part with otherwise working capital until the end of the fiscal year. At a 1-percent per month penalty for not paying advance taxes, companies may find the penalty cheaper than the cost of borrowing from banks. Finally, inflation continues to ease, which will be further enabled by the cenvat reduction and lowered petrol and diesel prices (which alone will lower inflation by about 60 basis points). Still declining inflation continues to add policy space for the RBI to further reduce rates.

COMMENT

¶13. (SBU) The government and the central bank continue to respond relatively aggressively to signs of stress in the economy and are using rather measured and calibrated responses. However, the tepid response in the stock market to the stimulus package and interest rate reduction suggests that the market has already priced in such moves and that expectations remain for further steps to be undertaken. The government's finances, already out of whack because of the record-breaking fertilizer and oil subsidy costs through the first half of the year, will likely fall further out of kilter, with estimates of the center's fiscal deficit to GDP climbing to 6-8% of GDP, from last year's 2.9%. One contact acerbically noted that worrying about fiscal deficits at a time of such global economic challenges is like worrying about cholesterol when a patient has cancer. Many may agree, but the government's more recent fiscal rectitude has been the primary reason behind India's sovereign rating improvements to investment grade in the last two years. High fiscal deficits could trigger downgrades which increase the cost of capital to India's private as well as public sector.

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